Mutual Fund Directors Forum Webinar:
Board Oversight of Profitability
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SUSAN FERRIS WYDERKO: This webinar, recorded in May 2015, is entitled "Board Oversight of Fund Profitability. Our guests today are Sara Yerkey, who is a partner with Management Practice, and Kelley Howes, who is an attorney with Morrison & Foerster LLP.

Sara Yerkey began her career in finance in 1996 with Standard & Poor's in their Financial Analysis and Product sector. In 2001 she shifted into the mutual fund industry, working for Janus in their Corporate Finance Division. Sara has worked for Management Practice since January 2007, focusing on the areas of mutual fund governance, contract renewal, and profitability analysis.

Kelley Howes is an of counsel in Morrison & Foerster's Investment Management Practice Group. She has experience with a wide range of legal, regulatory compliance, corporate governance, insurance and other matters relating primarily to the representation of U.S.-registered and unregistered investment advisers, transfer agents and broker dealers. Kelley has more than 20 years' experience in various investment management-related matters, and prior to joining her law firm she served in various roles within Janus.

Kelley and Sara, thank you so much for being with us here today. I'm going to turn the presentation over to you.

KELLEY HOWES: Thanks, Susan.

This is Kelley. We have a few topics that we want to handle today. And as Susan said, please, as we go along, if you want to raise any questions, type them in. Susan will be happy to interrupt us and get your questions answered on a real-time basis.

The topics we're going to cover today, first of all, a little bit of background—some judicial precedents, the objectives for analyzing profitability—secondly, a more current look at the regulatory focus and what the implications of that are for a board, specifically with respect to

profitability. And then Sara is going to spend some time talking about benchmarks and how you might look at this particular factor to assess reasonableness of profitability.

So if we flip to the next—thank you. We're going to start with judicial precedents, and just a little bit of background on this. As most of you know, Section 15 requires a board to annually review the Investment Advisory Agreement. It does not, however, prescribe what a board should be looking at when they consider the annual renewal of an advisory contract. And due to that, there has evolved this line of judicial precedent beginning with a case that everyone refers to as *Gartenberg*, which set forth the factors that boards generally look at when evaluating an advisory contract.

So, beginning with *Gartenberg*, the Court said that in order for an advisory fee to violate Section 36(b) of the 1940 Act, a fee had to be so disproportionately large that it bears no reasonable relationship to the services provided, and it could not have been the product of arms'-length bargaining.

As I mentioned, the *Gartenberg* Court identified several factors that a board has to consider when they review an advisory contract. Those include the nature and quality of the services provided, the performance of the fund itself, the cost of the services and the adviser's profitability, and whether the fees reflect economies of scale. What we want to focus on today, though, is really just the profitability, the profitability of the adviser and what a board should be considering when looking at that particular factor.

Before we get into that, I just want to make sure that everyone understands that we are taking a real thin slice here, looking at one particular factor that in no way is meant to suggest that this is the most important factor. All of the factors need to be looked at and considered and evaluated with respect to each fund that the board oversees.

SARA YERKEY: Kelley, just to jump in, so when you talk about each of the factors, are you talking about looking at profitability independently or each fund in context with each other?

KELLEY HOWES: Profitability in a vacuum is a data point without a lot of relevance. You have to look at each fund's profitability to the adviser but you also need to look at it in the context of the overall—the overall profitability of the complex—the adviser, what they are spending their money on. You can't just sort of look at one data point in a vacuum.

SARA YERKEY: Okay, and so in addition, when you're looking at an individual fund you don't also want to look at the profitability of that fund in relation to its performance, its relative performance and its relative expenses, for example.

KELLEY HOWES: Absolutely.

SARA YERKEY: Okay.

KELLEY HOWES: So going back to the slide here, it says securing the lowest possible fee is really not the exercise here. A board can demonstrate that it is fulfilling its fiduciary responsibilities by diligently and independently considering all of the factors laid out in the *Gartenberg* line of cases. It is not simply an exercise in the lowest cost.

The last bullet here sort of drives that home. This is a quote from the U.S. Supreme Court in the *Jones v. Harris* case where they said that, "Where a board's process is robust, a reviewing court should afford commensurate deference to the outcome of the process." In other words, it is less about the actual number per se and more about the level of dialogue, the level of independence, the level of diligence, the fact that the board does actually ask questions, engage management in a meaningful discussion, and keeps asking questions until they get the answer that they need.

So pausing for a second to look really at the objectives of analyzing profitability itself, high profits earned by an adviser, as I was saying, are not a bad thing. When the 1940 Act was amended in 1970, the Senate report was very, very clear that advisers are entitled to make a profit. Advisers are, after all, in business to make a profit and a cost-plus contact is not required or intended. So again, it's not an exercise in the lowest fee. I would argue that if you are driving toward the lowest fee, what you may end up doing is harming the adviser's ability to reinvest in its business to attract the right types of people, the right quality of analysts, the right level of portfolio managers.

And this is something that the board really needs to weigh, and this is part of the sort of rubric, if you will, within which you have to look at profitability. You can't simply say, well, that seems like too high of a profit number. You need to understand what the adviser is using its profits for and thereby make a determination that it is a reasonable profit level.

SARA YERKEY: I think, Kelly, that's a great point. Before, you mentioned securing the lowest fee is not the goal, and there's other things in the current environment as far as compliance and operations of the funds that the manager needs to invest in that may affect the profitability and where they need to be. And so that's a consideration as the board looks at the margins.

KELLEY HOWES: I think that's really important, particularly now when you look at the focus on things like cybersecurity and issues like that, that there are—there are very real, meaningful needs for reinvestment and that it's on an ongoing basis. And that is what the adviser needs to be spending their time on in addition to, obviously, managing the funds.

In that particular regard, there was a particular case in the string of cases, the *Schuyt* case, which had a pretty high level of pre-tax profitability. It was in excess of 77 percent in one method of calculating that profitability. And the Court was pretty clear in saying, you know, that can be justified based on the quality of services that a highly qualified and conscientious adviser is providing. In addition, in that particular case, the Court pointed out that the board was highly qualified and the board was very diligent and very engaged in the discussion with the adviser.

Looking at page 6, current regulatory environment, very recently there was an enforcement action which drew a little bit of attention to this particular factor in the advisory contract renewal process. That enforcement action is In the Matter of Kornitzer Capital Management. It was filed in April of this year. And in that case the issue was essentially that one of the members of management of the adviser was reallocating the expense of a particular executive's time, their salary, and not following the stated methodology.

So essentially, the methodology was that they were going to allocate time and expense on estimated labor hours, and that's not how they—how this particular individual was allocating the CEO's compensation. Instead, what he did was he looked at the adviser's revenue and expenses. He looked at revenue growth over the last fiscal year. He considered the profit margin that would result from a proposed allocation. And then he reallocated a percentage of the CEO's compensation to achieve a level of consistency of the adviser's reported profitability. So a couple of things happened here. One is there was a stated methodology and it was not being accurately followed. And two is, he was allegedly manipulating the numbers to get to a consistent profitability level.

One thing that I want to make sure that board members in particular think about when they're looking at this case is that the board in this case was not cited for any issues at all. The board asked the questions, got the reports, understood the methodology and had presumably no reason to believe other than the methodology, as stated, was being followed. But I think the language in the order is important because it does tend to really underscore the importance of the board following its process, asking its questions, understanding what the methodology is.

And I think what the SEC in part is saying here is, we understand you did your job, and notwithstanding that there are—nonetheless there were issues. So the respondents in this are not the board in any way, shape or form—although as an aside I'm sure it was not a lot of fun for that board to go through this process—but the adviser and a particular principal at the adviser.

SARA YERKEY: So, Kelley, the board, in this case, did their full due diligence.

KELLEY HOWES: That's right. I think they did, yes.

SARA YERKEY: And their responsibility would not be auditing the allocation process or in any way creating a methodology.

KELLEY HOWES: Right. As we get to a little bit further along, the board's responsibility is oversight. The board should not be auditing. The board should not be running the numbers. The board should not be creating a methodology. The board should be providing a level of oversight of the process, asking the right questions, and where they don't understand or don't agree, continuing to ask questions so that they get their—they get to a level of comfort with the answers that they're receiving.

Another thing that is not a particularly new development but nonetheless worth reiterating is registered funds have disclosure obligations in both the proxy, if they have a proxy, and their shareholder reports. And those disclosure obligations include a discussion of how the board evaluated the costs and profitability of an adviser from its relationship with the fund. It is, in fact, where the SEC, in the rule adopting release, basically came out and sanctioned—and agreed with the *Gartenberg* standard in terms of the factors that a board looks at.

Specifically with respect to cost and profitability, the SEC, in that adopting release, did call out that there is no need for any fund or its board to disclose proprietary information around how they structure their fee, how they allocate their costs, how they're getting to their expense levels and their profitability methodology. None of that needs to be disclosed. What does need to be disclosed is how the board evaluated that factor and all of the other factors, and how that evaluation contributed to the overall decision around the advisory contract.

Importantly—and you do see comments on this occasionally—boilerplate in this is really not sufficient. The boilerplate, it seems to me, is the recitation of the factors involved. Every board is going to look at the same factors because those are the factors that need to be evaluated, but every board is probably going to have a little bit of a different view of those factors. And in fact, individual members of a board may view that differently, and that probably should be called out as well, that one factor may or may not have been more important to a certain—a particular board member's evaluation.

So as you're looking at that disclosure and thinking about that disclosure, you want to make sure that it is—it accurately reflects the discussion at the appropriate level of specificity, but it also doesn't suggest that the board did not enter into a level of analysis and evaluation consistent with its fiduciary responsibilities. So you really want to be careful about crafting that disclosure.

SUSAN FERRIS WYDERKO: Now let me break in a minute. We've got a couple of questions that have come in about the case, the recent case in April. And I just want to hear you discuss what you think the SEC was really getting at with this case. Clearly the board has to approve the methodology. In this case the methodology was changed. Do you read this case as saying that it's inappropriate to change methodology or that the primary problem and the reason for the case was a failure to disclose that change to the board?

KELLEY HOWES: So as a general matter—as a general matter, I don't view it as best practice to shift your methodology with alarming regularity, right? I think you should have some level of consistency in your methodology. However, I don't think a methodology needs to be static. I don't think it has to be sort of written on a tablet of stone. If there are valid reasons for shifting a methodology, then it should shift.

That may reflect changes in the business. It may reflect changes in the adviser's structure. It may reflect different types of products that are being offered for the first time. All of those

things are going to shift the methodology, and rightfully so. The board should be able to rely on the adviser to apprise them of shifts in that methodology, the reason for that shift in methodology, and how it changed the numbers.

What I do think I would suggest to a board if I were advising them, is in light of this case, notwithstanding that you should be able to rely on the adviser to provide you with that information, it would be prudent to ask the question: Did you change the methodology? I would add it into my 15(c) questionnaire, quite honestly: Is this methodology the same? Did you change it? If so, how? And if you changed it, what was the net effect on the numbers?

Do you have any thoughts on that?

SARA YERKEY: I support Kelley in exactly what she's saying. We're actually going to discuss this on the next slide in regards to the director responsibilities on profitability, if you'd like to move forward, Susan.

SUSAN FERRIS WYDERKO: We also have a few more questions along this line, and let me just put them out on the table before we get to your slide.

So you have been saying that the board is entitled to rely on the adviser, and there are times, you say, when it is appropriate for the methodology to change, but not alarmingly so and not on a regular basis. Do you advise boards to retain a forensic accountant or some other kind of expert to give guidance as to the reasonableness or the suitability of the cost accounting methodology?

KELLEY HOWES: I do not, not unless a board has a reason to be concerned about it.

SARA YERKEY: I think that's a good assessment. If there is any reason a board doesn't have comfort in the process, there is a good reason to have a one-time possible audit of it, of the methodology and the resulting figures. However, on an annual basis it's not the board's responsibility, anything but oversight. And as Kelley said earlier, they're not responsible to create the methodology or audit the resulting numbers from that methodology.

SUSAN FERRIS WYDERKO: Okay, and then another question. You may be planning to address this. We've got a couple of questions about assessing profitability of subadvisers. And then in a separate strain I've got several questions about profitability of separately managed accounts. So maybe you can wrap in a conversation about those two issues as we go forward.

KELLEY HOWES: Okay, as we're sort of starting to move through the numbers we'll do that where we can. So I'm going to turn it over to Sara to just—

SARA YERKEY: Sure. We can move on to touch a little bit more on what the director responsibilities are.

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First and foremost, it goes without saying that the directors need to request the fund-by-fund profitability and a written explanation of that methodology. Kelley mentioned that in addition to that you would want any written explanation of anomalies that would exist from year to year. And there's no right way to calculate profitability, but as long as the board understands clearly how it was calculated and that it was consistent from year to year, that the board should gain comfort from that calculation.

KELLEY HOWES: I think that's really important. I think that at some level it would be comforting to have someone say, here is how you should calculate adviser profitability, but the advisers' businesses vary drastically depending on the types of funds, the type of account, the distribution methodology, the markets in which they might operate. And you cannot sort of—you can't sort of apply the same calculation methodology to businesses that vary that drastically.

So again, the board really needs to be conversant with the methodology and to be comfortable that it makes sense in light of the adviser's business and the service that it's providing to the funds.

SARA YERKEY: And methodologies may not change from year to year but that doesn't mean the percentages don't change from year to year. So, for instance, a lot of times you'll see time dedication of staff change year over year, which it should. If you've got different products and, as Kelley was saying, different things that drive your business, your staff is going to spend different amounts of time there.

And so the allocation numbers are going to change and you wouldn't want to see the exact same dollars allocated. The methodology therefore would have different results but the procedures wouldn't necessarily change. Now, if there was a methodology change, you would want—the board would want to see a restatement of the prior year with those significant changes.

KELLEY HOWES: Just a couple of things to comment on there. One is, in my view anyway, if those numbers are shifting, that is a trigger for the board to ask questions: Why are those numbers shifting. Explain, if you're using a consistent methodology, if there's a significant shift in a number, why is that happening, again, particularly in light of this case.

SARA YERKEY: That's right. So that goes to, again, right along with that, the board would be best served to have a trending profitability analysis. And this is going to show the board what the changes are. And that leads them to be able to ask intelligent questions and have information that shows them the changes that leads them to understand if there are economies of scale in their funds or why there are changes and what leads to that in profitability.

As you said again and again, Kelley, the important thing is to keep asking questions until you understand everything with the analysis. And the process is king.

KELLEY HOWES: The last thing in this slide—I'm just going to jump in real quick—is, again to reiterate, the board's responsibility is oversight, oversight of the overall service provided under the advisory contract. That includes the profitability, but that is only one of the factors when you're looking at the advisory contract.

SARA YERKEY: Well, and we've talked about it: When is the trigger? When is the trigger when your numbers change year over year that your profitability may be high or may be low? When does the board get involved and ask the question? What does the number mean and what shall we do about it? And this really is going to depend from board to board. This goes to, are you asking the questions?

Do you want to switch to the next slide?

SUSAN FERRIS WYDERKO: Well, before we get to the next slide I've got another couple of questions here.

Talk to us a little bit about fund-by-fund profitability. You have mentioned it, and I think many boards do do that, but as one of the people on the webinar points out, the only litigated case since *Gartenberg* didn't require fund-by-fund profitability to prevail. And as several others have pointed out, fund-by-fund profitability might be the least most interesting or useful statistic that a board sees since it's so highly arbitrary.

KELLEY HOWES: Yes, I would agree with that last comment. I think it is important for a board to look at fund-by-fund profitability because it gives—it could give them a sense, for example, of where the adviser might be spending an inordinate amount of time. And the board obviously has a responsibility to look out for the shareholders of each and every one of those funds. If the numbers suggest that a particular fund is receiving a disproportionate amount of time or attention or something of that nature, that could be a trigger to discuss that: Is that an appropriate use of the adviser's time and resources or is it not?

SARA YERKEY: I think that it is the responsibility of the board to discuss the profitability on a fund-by-fund basis and not as a collective, the same as you discussed performance and expenses. And so reviewing it at that level, while difficult, and while there aren't individual comparable benchmarks across the industry, it's something that the board needs to use their time, and quite frankly their knowledge and intellect and their oversight to do. You know, where this trigger lies of is this excessive is going to have to depend on that insight and knowledge. And again, the best tool you have is the trend of the profitability of each of those funds and the understanding of the methodology that creates that profitability.

Now, we hesitate to ever say look at the profitability one year, because a lot of times there's a delay and you may have your profitability jump around, especially if you've got small funds or indexed products. And also there's a delay—you may have your expenses follow your revenue at a delay and so you may see your profitability jump one year and it will dive back down the

next year. But these are questions that have to be discussed with your adviser. And again, it goes back to the questions and the oversight and the knowledge of your board.

SUSAN FERRIS WYDERKO: All right, so let me break in again and ask another question that's come up.

Kelley, this might be for you. Do you advise your client boards to actually develop a methodology and then require the adviser to apply it? Do you believe that that might impact in some way the board's legal exposure?

KELLEY HOWES: I would not advise a board to do that. I think that a board—again, the board's responsibility is oversight. The board's responsibility is not to dictate the methodology by which a profitability margin needs to be calculated. They really need to understand the way the adviser looks at his business and therefore understand how the adviser is approaching the services that it provides to the funds. Dictating a methodology, it seems to me, would impose a board's bias on the adviser's view. And you really want to ask the questions of the adviser: How are you looking at this? Why do you look at it that way? How are you approaching your business?

Does it possibly expand a board's legal exposure if they are dictating the methodology? I suppose that's possible, yes. I think that the board is then stepping into more of a managerial role and taking over a level of responsibility that is inconsistent with that of a fiduciary who is responsible for the overall function of the board—sorry, the fund.

SUSAN FERRIS WYDERKO: Okay, now let me ask another question that's come up. Actually we've got a couple along these lines.

We have talked a little bit about methodologies that allocate cost based on time. I assume you also mean to include methodologies that allocate particular costs by asset size in a fund, but what about comparative profitability information comparing the complex to publicly traded fund companies? Do you think that's a worthwhile comparison to make?

SARA YERKEY: So, Susan, we can address that now or we've got some specific slides that are coming up that will address that.

SUSAN FERRIS WYDERKO: Okay, why don't we wait then? Are we ready for the next slide?

SARA YERKEY: Sure.

So as we were talking about, the benchmarks are difficult. There is nothing that's going to be black and white. There is not publicly reported information. It's not required to have the fund-by-fund individual benchmarks. So what we've got is limited to specific guidance that Kelley has been discussing earlier today. And we've got the things like *Schuyt* that have the 77

percent that has been deemed not excessive but has also stated that this could very well be excessive in other situations.

Also, it may be the case that other funds would be deemed not excessive if it was even higher than this, because *Schuyt* also had shareholder servicing included, and there might be other considerations. So while these are a few cases out there that give some numbers, it's nothing that would be held to each firm if a similar situation came up.

We do know that the profitability is intended to be assessed on pre-tax advisory fees. So it's one place we can start with. However, it does not relieve the board. Earlier you asked the question: Well, it's so willy-nilly. There's no black and white. Does it relieve the board of having to assess and is it worth the time? It definitely is the board's responsibility and it has to be a conscious and fully informed process, and that's not for question.

So we can move to the next slide. And as we talked about, the board's understanding and agreeing with the assumptions of the profitability calculations is really key. And we did talk about time and effort, but there's a hundred different ways from Tuesday that you can create these allocation methodologies, and most often we'll see multiple methodologies included. And so, as you mentioned, assets is one possible methodology, revenue, time dedication. We even see trade execution, fund flows. And those are just some examples. Most importantly, though, again, it can't be emphasized enough that—the documentation and the understanding and the consistency of the methodology.

KELLEY HOWES: And we've talked a little bit about consistency, but also looking at things on a fund-by-fund basis.

SARA YERKEY: Yeah.

SUSAN FERRIS WYDERKO: When you're talking about consistency, I assume that means you can't take fund X and fund Y in the same complex and use two different methodologies, that you would use a consistent methodology across a complex. Or do you see anyone using different methodologies maybe for different types of fund or things like that?

SARA YERKEY: When you talk about methodology, you can use different methodologies, and should between funds as far as are you allocating different time to different funds? Are you allocating different effort and for sure different trade? Now, if you're saying use different methodologies—

KELLEY HOWES: You wouldn't want to use—consistently use methodology A on this fund—

SARA YERKEY: Right.

KELLEY HOWES: —and methodology B on this fund because then you're sort of looking at apples and oranges from a profitability standpoint.

SARA YERKEY: That's right. You wouldn't want to completely reverse your idea.

KELLEY HOWES: Right.

SARA YERKEY: So taking us to the next slide, potential influences on profitability, when the board is considering allocation methodologies and the logic behind them, sometimes it may help—and this goes to your question, Susan, on when you get to industry-level comparisons. At the fund level it may help to kind of consider what's driving firm profitability across the industry and how you fit into that.

Across the industry firms have, obviously, different products or different sized distribution, different channels, and it equates to different margins across the industry. And one example is size. So if you look at the chart in the bottom right-hand corner, we've looked at a collection of publicly reporting firms and their size and the correlating operating margins. So you can see here the dark line along the bottom is the size in assets. And if you look at the correlating margins you see that there isn't any correlation.

So with this you can kind of think about it as a director: All right, does it make sense to allocate purely by assets? And possibly, unless in your situation that the allocation on assets alone may not make sense unless all the other factors in your firm hold constant, such as the product mix, you know, if you've got active versus passive, the compensation structures and distribution methods. But this is a prime example. If your methodology is just allocated across assets, we can see that in a firm situation across the industry that doesn't make sense. So possibly internally that wouldn't very much be logical either.

KELLEY HOWES: I think this is a great chart. And I think one of the other things that it does drive home is that profit margins, operating margins, vary wildly across this industry because—if these are the publicly traded asset managers. So in response to the question of should you be looking at that, I don't see any reason why you would not want to be aware of it, but I think you would also want to understand it in a context such as this.

SARA YERKEY: Right. So that moves us to the next slide.

SUSAN FERRIS WYDERKO: But before we get there—

SARA YERKEY: Sure.

SUSAN FERRIS WYDERKO: —I want to push you a little bit on this slide, the one that says "potential influences on profitability." One of our participants points out that if you're really going to evaluate profitability, you probably are going to need a lot of non-fund-related information such as separately managed accounts, hedge funds, et cetera, to assess the reasonableness of the adviser's cost allocations. And obviously that can be sensitive. Should

that information be obtained by the board? And if not, how can the board really judge the reasonableness of the profit calculations with respect to the funds?

KELLEY HOWES: So just to make sure I understand the question, the question is essentially should the board be looking at the fund profitability without reference to the overall adviser profitability from other types of products?

SUSAN FERRIS WYDERKO: Yes, or at least knowledge of how costs are being allocated to the other types of products that the adviser runs.

KELLEY HOWES: I think I would push an adviser fairly hard on that. Again, an adviser is running a business and they are entitled to run the business consistently with the interests of their shareholders. However, an adviser is also a fiduciary and they should not lose sight of that. Among other things, it seems to me that that means an adviser should not be actively cross-subsidizing across types of plans, which is sort of what I'm inferring from the—what I'm inferring the concern to be from the question.

SARA YERKEY: Right.

SUSAN FERRIS WYDERKO: Yes.

SARA YERKEY: If I'm understanding it correctly, then the board has the right to understand why the costs are being allocated between the funds and other types of accounts and the adviser.

KELLEY HOWES: Yeah, I agree with that. I think that is a reasonable question to ask. I think it is reasonable to understand if the fund shareholders are bearing the brunt of a disproportionate level of costs, for example. The board needs to understand that.

SARA YERKEY: Yes, if a portfolio manager is overseeing the funds and institutional accounts, they should understand, and have the right to understand, how the expenses of that group are being split between those products.

KELLEY HOWES: Which is not to suggest that there aren't perfectly rational reasons for those cost allocations to differ among—

SARA YERKEY: Absolutely.

KELLEY HOWES: —types of clients and types of distribution methodologies, but I do think the board should ask the questions about it.

SARA YERKEY: And that's a great example of questions that should be asked.

KELLEY HOWES: And I think the board—the board needs to be sensitive to the proprietary nature of the information that they're asking an adviser to share, and to get to a level of

comfort with the information that's being shared. I don't think that a board should spend time sitting at the financial reporting desk and understanding how all the money flows around the adviser. That's not their job.

Does that answer the question?

SUSAN FERRIS WYDERKO: Yes, it does. Shall we go to the next page?

SARA YERKEY: Yes.

KELLEY HOWES: Yes.

SARA YERKEY: This goes to where can benchmarks be used by the directors? And while there aren't the benchmarks available at the individual fund level, the directors can obtain some industry information at the firm level and use this as a general guideline to have educated discussions. And this chart is just an example, so if a group has a collection of funds—and here we've just named them equity alternatives, fixed income, and money market as examples—and then they have a total complex advisory profitability roll-up, this is where you can get an industry-wide comparison of publicly reported firms.

So your firm might have a roll-up of 49 percent, for example, of your different funds and then the industry comparison currently might have an average of 55 percent. So your board can take this comparison and say, here is where we are and here's where the industry average is, and take your discussions from there. And then of course you're going back to, well, here are individual funds and here are the trends over the last few years, and what does that mean and where are we sharing our economies of scale with our shareholders?

The next slide is—this is the actual industry trend over the last 10 years. And this also is just information for the directors to be able to also have the background for their informed discussion. And the last two years you'll see 2013 and 2014 just as information. You know, we think all the equity funds and assets are flowing in, the industry is growing, but honestly the average of the advisory margins aren't growing that much, basically because of shifts in where the assets lie. We've gone from actively managed to more indexed products.

And you also see the variable compensation often flows with the increase in assets and the improved performance. So a lot of times you're not going to see big jumps in margins even though we've got the increase in assets. So again, these are just examples of benchmarks you can have to help the discussion.

And then the next slide. This is just another example of while the board is going to have a responsibility to discuss the fund-by-fund advisory margins, this is for the director to assess the profitability of the individual channels on the total business level. And this separates—gives again the example of where a board might look at their different business channels and then the total roll-up investment profitability levels compared to the industry profitability.

Susan, if you can flip to the final slide. And this provides the insight to the impact of the other channels on the adviser stability and just how much it drops from the advisory once you include the shareholder services and the distribution to the total investment profitability.

KELLEY HOWES: The board is required to look at the advisory function outside of distribution, but I do think that this is important information for a board to be aware of, to see it all on a more holistic level, to get a better understanding of the advisor's business.

SARA YERKEY: Yeah, it gives insight to the adviser stability and, quite honestly, just what it takes to run the entire business.

KELLEY HOWES: And that's an important—that's an important factor, right, is the ability of the adviser to pay for its business, to run its business and to do so at the highest level.

SARA YERKEY: Right, because you might be looking at these 50-to-60 percent margins at the advisory level, but at the end of the day you're looking at the 38-pecent pre-tax margins on the entire business.

KELLEY HOWES: Right.

SUSAN FERRIS WYDERKO: So then what you're saying is that it's perfectly appropriate for a board to ask for and to receive profitability numbers both including and not including distribution?

SARA YERKEY: Yes.

KELLEY HOWES: Yes.

SUSAN FERRIS WYDERKO: Okay. And so then a couple of people have asked questions about where these benchmark statistics are coming from. You're describing them as publicly-held companies. Can you give us a little more color as to where the numbers are coming from?

SARA YERKEY: Yes. So there's a few different places you can get these. We've provided—these specific numbers come from management practice but there are different firms that provide similar statistics. And these are publicly available figures that are compiled. Obviously they are on—these are on about 20 firms that provide their financials. And they're both on the advisory and then, at the end of the day, the total investment margin.

SUSAN FERRIS WYDERKO: So these are the publicly traded advisors?

SARA YERKEY: They are, but these are firms only that are involved in investment activities. So there are a lot of firms out there that do additional things and you can't [isolate] only the investment activities as comparables because obviously the groups we're talking about only

want to look at the advisory, and there are a lot of firms out there that combine other things and therefore it's not comparable. So it's a small universe that we can actually gather that are publicly reported.

SUSAN FERRIS WYDERKO: All right, so I've got a bunch of really good questions here. Let's start out.

In computing the all-in profitability of the adviser, what about the funds that are being operated at a loss? Should they be excluded from that computation? That's where the adviser has waived some or all of its fees to keep the overall expenses down. That might seem to lead to the profitable funds subsidizing the less profitable ones, however. So what do you think about that?

KELLEY HOWES: The question is whether that fund should be excluded from the overall profitability.

SUSAN FERRIS WYDERKO: Yes.

KELLEY HOWES: I don't believe that they should be. The adviser is making a decision on maybe it's a new fund, maybe it's a new distribution channel. Maybe it's a very small fund. The adviser is making a business decision about that particular fund and that does factor into the overall assessment of the adviser's business and profitability.

SARA YERKEY: And it's a very common—it's a very common thing that you see. There will be a few—especially in indexed funds they'll be very small funds or, you know, when you've got the money market funds and things like that.

SUSAN FERRIS WYDERKO: Okay, another question. Talk to us about a board—let's take a board that has a strong process. In your opinion, where are the board's greatest points of vulnerability with regards to profitability? In other words, the boards can control their own process, and let's just say that they've done that and made it robust. Where is the greatest area of vulnerability for that board?

KELLEY HOWES: I think that a board has—if it has a strong process and it is following its process and can demonstrate that it is doing so, it's 90 percent of the way there. Where it can fall down is if it isn't asking—if it isn't getting the information that backs up its process questions. So it's one thing to ask a question because you have a robust process and another thing to just sort of take a really high-level answer to that question if it isn't adequate information. So to be diligent enough that you are getting underneath the—sometimes getting underneath the immediate response provided by the adviser, right, to ask some of the more difficult questions.

SARA YERKEY: So, Kelley, I'll throw an example out there to you. A fund that is a large fund that has—that is reporting high profitability margins in the 80-90 percent range over 3, 4, 5

years and their fund has not seen any decrease in expenses, and they are not necessarily comparatively in that great of an expense ratio and their performance is not in a relatively great performance place, in that situation is their profitability maybe at greater exposure?

KELLEY HOWES: Well, I think what you're sort of getting into is a discussion of economies of scale—

SARA YERKEY: Yes.

KELLEY HOWES: —which is a whole other hour.

SARA YERKEY: And that's what I'm—

[Laughter.]

SARA YERKEY: We are getting close to the end of the time, but is there profitability—

KELLEY HOWES: No procedurally that's not exposing the board—

SARA YERKEY: Right.

KELLEY HOWES: —but as far as if you've seen—if you've seen your profitability increase over 3 or 4 years and you're not seeing the economies of scaled shared with your fund holder, and at the same time you don't have stellar performance, great expense ratios and you don't have break points on your fund, maybe that's when the board can ask more questions.

SARA YERKEY: And I think an important part there is to go back to the suggestion of trends. So you are looking at the trends of the profitability across several years but considering that in the context of performance and possible fallout benefits and economies of scale. It is easy enough, it seems to me, to simply say, well, this fund has had consistent profitability over the last 3 years and we've approved it every year so why wouldn't we approve it again? Well, because it needs to be in context.

SUSAN FERRIS WYDERKO: All right, so let me take you in a different direction for this question. You know the SEC—we all know the SEC has a distribution-in-guise sweep. Are you advising your clients if there's anything specific or different that the board should be doing to examine the profitability of sub-TA arrangements or the distribution arrangements?

KELLEY HOWES: I don't know that I would recommend looking specifically at profitability sort of in the context that we've been discussing it with respect to sub-TA and distribution arrangements. That's not to suggest that boards should not understand the expenses of those arrangements and how those expenses are being paid for and who is paying those expenses—is it the adviser; could it be the fund—and understanding the services that are being rendered.

But I don't think that I would lump it into sort of this sort of an analysis, which we sort of looked at in the context of the advisory contracts. I think—

SUSAN FERRIS WYDERKO: All right. Go on.

KELLEY HOWES: I think, really, Susan, one of the outcomes of that distribution in guise sweep, first of all I think, for better or for worse, we probably will end up having some regulation by enforcement and we will get a better sense of what the staff might think about that, but it will take some time for that to generate. In the meantime, I think boards should be looking at those arrangements directly and more thoroughly.

SUSAN FERRIS WYDERKO: All right, fair enough. So let me now, in our closing minutes, switch gears on you entirely. Talk to us about what boards of funds with unitary fees should be considering with respect to profitability. Anything different?

KELLEY HOWES: Well, I think a board still needs to understand what—they're paying one fee and they're relying on the adviser to handle all of the—essentially the subcontracts and to pay all of the other fees. I think they still need to understand how the adviser is doing that. What are the adviser's—what is the adviser's requirements to pay out? Are they doing so? What does that do to their economies of scale? At some level an adviser with a unitary fee is really taking the brunt of the shifts in the business. In some years they may have a higher profit and some a much lower profit just because they are bearing a lot of the exposure to the market and the performance and that sort of thing if they've just got that one fee the whole way through.

SARA YERKEY: Right.

KELLEY HOWES: But I don't think it necessarily changes the need to look at profitability. I think you still need to understand what the adviser is using its money for.

SARA YERKEY: No, I think it's—back to Kelley's point, you're still going to need to do the trend analysis. Your results may be higher than the next person but there's a reason for it, but your trends are still going to change year over year and you're still going to need to understand why. And there's still going to be a methodology of why you allocate expenses between each of the funds differently.

SUSAN FERRIS WYDERKO: That makes perfect sense.

Sara, Kelley, this has been a terrific conversation. I can't thank you enough for being on with us today to discuss profitability. As you say, we'll have to have you back for another hour to discuss economies of scale and some of the other issues that came up. Thanks so much for being with us today.

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